

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 02-0612  
INDIVIDUAL INCOME TAX  
For The Tax Period: 1999**

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**ISSUE**

**I. Individual Income Tax – Exemptions**

**Authority:** IC 6-3-1-3.5, IC 6-8.1-3-3, IC 6-8.1-5-1, 45 IAC 3.1-1-5, *Johnson County Farm Bureau v. Dep't of Revenue*, 568 N.E.2d 578 (Ind. Tax Ct. 1991), 1999 IT-40 *Instruction Booklet*.

Taxpayer argues that the Department erred in its assessment of additional income taxes on the ground that Taxpayer overstated the number of exemptions claimed on his 1999 Indiana individual income tax return.

**II. Tax Administration – Penalty**

**Authority:** IC 6-8.1-10-2.1, 45 IAC 15-11-2.

The Taxpayer protests the Department's assessment of a negligence penalty.

**STATEMENT OF FACTS**

Taxpayer was assessed individual income tax after an adjustment was made to his 1999 IT-40 Indiana Full-Year Resident Individual Income Tax Return.

Taxpayer claimed two exemptions on line 6 on his federal Form 1040 consisting of himself and one dependent child. Thereafter, Taxpayer filed a single IT-40 state return reporting income received during 1999. On the IT-40 return, Taxpayer claimed two exemptions on line 8 (exemptions claimed on your federal return) plus three (additional exemptions for dependant children) on line 9.

On September 27, 2000, the Department issued Taxpayer a Form PFC disallowing all the exemptions claimed on Line 9 with the reason of "[e]xtra exemptions claimed". On July 23, 2001, the Department issued a notice of "Proposed Assessment".

On August 10, 2001, the “Proposed Assessment” was canceled. Subsequently, a second “Proposed Assessment” was issued on August 26, 2002 for the adjustments made to the 1999 IT-40. More facts supplied as necessary.

I. **Individual Income Tax: Exemptions**

**DISCUSSION**

On his federal return, Taxpayer claimed himself and one of his dependent children as exemptions. Taxpayer chose not to claim two dependent children on the federal return. Taxpayer argues that he was entitled to claim all three exemptions on his state return even though he chose to claim only one on the corresponding federal return. Taxpayer maintains that his decision, not to claim two of his three dependent children on the federal return, did not preclude him from claiming them as “Additional Exemptions” on the state return.

Taxpayer argues the IT-40 instruction booklet does not state that he is required to limit the exemptions claimed on “Line 9” to either what was claimed on the federal return or what he reported on “Line 8”. Rather, he states he is entitled to claim those exemptions in which he was eligible to take on the federal return. Specifically, he points to the 1999 IT-40 instruction booklet which states: “If any dependent(s) you are eligible to claim on your federal return also meet the *Dependent Child Definition* above, enter that number in the box on line 9”. He states that since the three dependents claimed on Line 9 meet the “Dependent Child Definition”, the Department erred when it adjusted his return.

In understanding whether Taxpayer is allowed to claim the three “Additional Exemptions” on Line 9 of the Indiana IT-40, we must also look to Line 8. Insofar as relevant to Taxpayer’s “Line 8” deductions, IC 6-3-1-3.5(a)(3), (4) states that the Indiana taxpayer is to “Subtract one thousand dollars (\$1,000), or in the case of a joint return filed by a husband and wife, subtract for each spouse one thousand dollars (\$1,000). Subtract one thousand dollars (\$1,000) for each of the exemptions provided by Section 151(c) of the Internal Revenue Code. Insofar as relevant to Taxpayer’s “Line 9” deductions, IC 6-3-1-3.5(a)(5)(A) permits an Indiana taxpayer to “subtract one thousand five hundred dollars (\$1,500) for each of the exemptions allowed under Section 151 (c)(1)(B) of the Internal Revenue Code for taxable years beginning after December 31, 1996.”

The statutory formula is straightforward; an Indiana taxpayer may claim a \$1,000 exemption on Line 8 of his Indiana return if that exemption is allowed under I.R.C. § 151(c). The Indiana taxpayer may claim a \$1,500 deduction on “Line 9” of his Indiana return if that exemption is allowed under I.R.C. § 151(c)(1)(B). There is nothing apparent in the statute which requires –as a condition precedent to claiming those Indiana exemptions – that Taxpayer first claim the identical exemptions on his federal return. The explanatory language on the 1999 IT-40 return is equally straightforward; Line 8 on the form states that the taxpayer is to report the “[n]umber of exemptions claimed on your

federal return.” In this case, Taxpayer claimed two exemptions which is what he claimed on his federal return.

The IT-40 also states that the taxpayer is entitled to claim an [a]dditional exemption for certain dependent children” and to report that number on Line 9. The instruction booklet states that, “An additional exemption, which has been increased to \$1,500, is allowed for certain dependent children”.

Taxpayer contends that the number that may be “eligible” to be taken on the federal return is distinguishable from the number that was actually taken on the federal return. However, Taxpayer misinterprets the instructions for Line 9 to include exemptions for additional dependents to those exemptions claimed on Line 8, when in fact, Taxpayer is allowed an additional exemption for certain dependents claimed on Line 8. This is clarified in the instructions which state in relevant part:

*Line 9 – Additional Exemption for Dependent Child*

*An additional exemption, which has been increased to \$1,500, is allowed for certain dependent children....*

If any dependent(s) you are eligible to claim on your federal return also meet the the *Dependent Child Definition* above, enter that number in the box on line 9.

*Example – John and Lisa claimed their 12 year old daughter Sarah as an exemption on their federal return. Since Sarah is their daughter, is under the age of 19 and was claimed as an exemption on her parent’s federal tax return, John and Lisa will claim one (1) exemption on line 9 for a total of \$1,500. (Emphasis added)*

Note: Not all dependent children eligible to be claimed as exemptions on the federal tax return will be eligible for this additional exemption. For instance, if you claimed a grandson or nephew as an exemption on your federal tax return, you should also claim an exemption for them on line 8. However, since he doesn’t meet the *Dependent Child Definition* above, you won’t be able to claim the additional exemption on line 9.

*1999 IT-40 Instruction Booklet, pg. 15.*

Nevertheless, 45 IAC 3.1-1-5(B)(4) directs Taxpayer to “[s]ubtract \$1000 for each exemption taken on the Federal return for taxpayer or spouse aged 65 or above...” and to subtract “\$500 [now \$1,500] for each exemption *taken on the Federal return* for a qualified dependent”. *(Emphasis added).*

The legislature has delegated to the Department the authority to interpret and apply the tax statutes. IC 6-8.1-3-3(a) states the “The department shall adopt, under IC 4-22-1,

rules governing: (1) the administration, collection, and enforcement of the listed taxes; (2) the interpretation of the statutes governing the listed taxes; (3) the procedures relating to the listed taxes; and (4) the methods of valuing the items subject to the listed taxes.”

There is nothing to indicate that the Department acted beyond its authority in promulgating a regulation mandating that Indiana taxpayers first claim the exemption on their federal returns before claiming the exemption on the corresponding Indiana return. “A rule issued by an agency pursuant to its statutory authority to implement the statute has the force of law.” *Johnson County Farm Bureau v. Dep’t of Revenue*, 568 N.E.2d 578, 584 (Ind. Tax Ct. 1991).

Consequently, The Department correctly denied two of the three exemptions. However, Taxpayer is entitled to one exemption on Line 9 for a dependent he claimed on Line 8.

Taxpayer also argues that since the original “Proposed Assessment” was canceled on August 10, 2001, the Department cannot create an assessment for the same adjustment. Pursuant to IC 6-8.1-5-1(a), “If the Department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment on the amount of the unpaid tax on the basis of the best information available to the department.” Here, the first assessment was canceled in error. The Department reasonably believed that Taxpayer incorrectly reported the amount of tax due and correctly issued the second “Proposed Assessment”.

### **FINDING**

The Taxpayer’s protest is denied in part and sustained in part. The Department correctly denied two exemptions which were not claimed on Line 8 of his 1999 IT-40. However, Taxpayer is entitled to claim one exemption on Line 9.

## **II. Tax Administration – Penalty**

IC 6-8.1-10-2.1(d) allows a penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Also, 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. The Department finds that Taxpayer demonstrated reasonable cause for their failure to pay tax.

### **FINDING**

The Taxpayer’s protest of the penalty is sustained.